



State Investment Commission
Monthly Meeting Minutes
Wednesday, April 23, 2014
9:00 a.m.
Room 205, State House

The Monthly Meeting of the State Investment Commission (SIC) was called to order at 9:07 a.m., Wednesday, April 23, 2014 in Room 205, State House.

I. Roll Call of Members

The following members were present: Mr. J. Michael Costello, Mr. Thomas Fay, Mr. Robert Giudici, Ms. Paula McNamara, Mr. Thomas Mullaney, Ms. Marcia Reback, Mr. Frank Karpinski, and General Treasurer Gina Raimondo.

Also in attendance: Mr. Joe Grogan, Mr. Nat Evarts and Mr. Charles Cullinane of State Street Global Advisors; Mr. Thomas Lynch of Cliffwater, alternative investment consultant to the Commission; Ms. Jessica Brennan and Ms. Janine Feng of The Carlyle Group; Mr. John Burns, Mr. Allan Emkin and Mr. David Glickman of Pension Consulting Alliance (PCA), general consultant; Ms. Susan Leach DeBlasio of Adler Pollock & Sheehan P.C., legal counsel; Ms. Faith LaSalle, Esq., Chairperson of the Rhode Island Higher Education Assistance Authority (RIHEAA) Board of Directors; Ms. Anne-Marie Fink, chief investment officer, and members of the Treasurer's staff. Treasurer Raimondo called the meeting to order at 9:07 a.m. Mr. Andrew Reilly was absent.

II. Approval of Minutes

On a motion by Mr. Giudici and seconded by Mr. Fay, it was unanimously

VOTED: to approve the draft of the minutes of the March 26, 2014 meeting of the State Investment Commission.

A motion was then made by Mr. Mullaney and seconded by Mr. Costello, and it was unanimously **VOTED: to approve the draft of the minutes of the March 26, 2014 executive session of the State Investment Commission.**

III. Equity Indexes and Trading

Mr. Grogan gave a brief overview of the relationship between ERSRI and SSGA. Currently, SSGA manages slightly more than \$4 billion on behalf of ERSRI. By placing these assets in passive portfolios with SSGA, the plan has gained exposure to certain asset classes while dramatically reducing the cost in the form of management fees and transaction cost. He added that SSGA employs rigorous governance standards, and offers complete investment transparency and risk management. Mr. Evarts reviewed what SSGA is doing to minimize trading costs. He noted that, by market estimates, roughly 80% of high-frequency or algorithmic trading is valid, legitimate and authorized market-making. The rest is related to statistical arbitrage, latency arbitrage and the more edgy parts of high-frequency trading, which are the smallest amounts.

He quoted a Transaction Cost Analysis (TCA) report that stated trading cost for institutions were roughly 0.23% in 2002 and are now estimated to be roughly 0.11% for 2013.

Mr. Evarts explained the structural component to high-frequency trading as it exists today. In 2005, the SEC passed Regulation NMS. The regulation was implemented to increase competition between

trading venues. This rule made competing on price paramount, which in turn made speed vital for markets to remain robust and work correctly.

Mr. Evarts noted that he sits on a committee along with other top industry participants to discuss topics such as improvements to the trading architecture. This committee focuses on keeping transparency, fairness, good governance, market stability and overall liquidity.

He described how SSGA seeks to lower costs on its own trading. SSGA has an internal cross process to match orders within the firm, which lowers cost and reduces overall market impact, since these cross transactions never make it to the market. There are no commissions on those trades. Even when it goes out to the market, SSGA's commission rates, in general, are low. As competition has grown and technology advanced, commissions have declined and that has benefited investors.

Mr. Evarts gave some background of the SSGA trading desks. No matter where a client executes globally, SSGA has a dedicated trader for the passive index funds. That trader is fully responsible for managing and monitoring transaction costs versus the benchmark. In deciding where to trade, SSGA looks at all liquidity pools based on value of liquidity and the prices at which they provide it.

He said high-frequency trading is one and the same with algorithmic trading. SSGA uses lots of different tools to manage execution impact cost, exposure and risk. About 70%-75% of order flow is executed by the traders themselves through electronic means, so they can manage impact cost vs benchmark, opportunity cost and total cost. Keeping the order (as opposed to giving it to a broker) gives SSGA's traders anonymity and flexibility to best work within the confines of the marketplace. Any orders that are entered on any of SSGA's equity desks have benchmarks associated with them. Those benchmarks relate to what they are trading against. The Transaction Cost Analysis (TCA) group at SSGA has over 17 million records of equity transactions in their database. They have been doing Transaction Cost Analysis since 2001.

Mr. Evarts reviewed the ways SSGA maintains consistent standards among the tools they utilize as well as their providers. He noted that SSGA also employs a third party TCA vendor to verify their findings and to ensure their internal TCA offering is consistent with market practices. He feels the rules put in place best protect their clients from adverse selection and predatory tactics that may exist. The board asked questions.

IV. Private Equity Recommendation—Carlyle Asia Partners IV

Ms. Fink said she and Cliffwater had looked for investments where it might be easier to generate return in light of managers saying traditional buyout markets being frothy. In doing so, they came up with Asia. In Asia (excluding Japan), public companies trade at 12 times earnings whereas in the U.S. it's 17 times. They believe if companies are less expensive in the public market, it's probably a great entry opportunity for private equity buyers.

Ms. Brennan gave a brief introduction of the Carlyle Group. Carlyle Group was one of the first private equity funds to open offices in Asia. They have 700 investment professionals globally with about 20% in Asia, where they have been successfully investing in Asia since 1998. They have ten industry groups they rely on globally.

Ms. Feng gave a brief overview of the Carlyle Asia track record. She noted that they are one of the oldest private equity funds in Asia. So far, they have invested \$6.7 billion in 32 companies across the region. They have also distributed \$11.2 billion to investors, the highest amount among their peers. The net return on capital is about 2 times or a net IRR of over 20%. She noted that one of the reasons for their track record is their stable and experienced team.

Ms. Feng reviewed their distributions and pace of investment. In Asia, the exits are not as predictable but Carlyle Group has demonstrated that they can effect exits over time and over cycles, primarily through strategic sales.

Ms. Feng reviewed the senior leadership of the fund and how they have expanded their deal team as they've grown. They have also brought in operating directors that have more than 20 years of experience in managing businesses and corporations in different industries. These operating directors help with diligence as well as operations after investment.

She then reviewed the markets and industries they cover. They cover most of the Asian geography except Japan. The regions they cover are considered high-growth regions. She noted that they will be increasing their healthcare exposure in the next fund.

Ms. Feng gave an overview of their strategy by region. China has about 40% of their investments and they see that continuing. China has about half of the GDP of the regions they cover. In the next fund they expect to see more Southeast Asia exposure. Part of their business model comes from industry expertise. They are very active in portfolio companies, not just through board representation but also through management rights. They have appointed more than 40 senior executives among their portfolio companies. Through operations, directors and global partners they create value and work together with the company owners as well as shareholders. And they eventually exit through a strategic buyer or IPO. Their active involvement is the main driver of their value, so their strategy is not solely dependent on the capital markets.

For fund IV they are targeting \$3.5 billion and expect the final closing at the end of May. The hurdle rate for incentive fee is 8% with management fee of 1.5% on committed capital during the investment period and 1% on invested capital thereafter. It is a five year investment period on a 10 year fund.

Carlyle has at least \$250 million of their own capital committed.

The board asked questions.

On a motion by Mr. Costello seconded by Ms. Reback, it was unanimously

VOTED: to approve the \$30 million investment in Carlyle Asia Fund IV.

V. Hedge Fund Reallocation

Ms. Fink said that the reallocation of these funds is part of the continuing effort to reduce the beta in the portfolio.

Mr. Lynch noted that the reallocation will help reach the target rate for the equity hedge fund portfolio, upgrade the manager lineup, and reduce the beta in the portfolio.

He gave a brief update on performance as of March 31, 2014. The return for the equity hedge fund portfolio has been 10.27% annualized with a risk of 4.05%. The return for the real return portfolio has been 5.58% with a risk of 2.37%. The combined portfolio has had a return of 8.13% with a risk of 3.06%. Overall, the portfolio has a good rate of return for the low risk taken. The hedge funds have also outperformed their relative benchmarks. The overall combined hedge fund portfolio has beaten the HFRI Fund of Funds index by over 3% with lower risk. The global equity hedge fund portfolio has beaten the HFRI Equity Hedge index by over 2% and with a third less risk. The real return portfolio has outshined T-bills and the Barclays Aggregate. Overall in the portfolio, the majority of return is coming from alpha and it has a lower beta exposure relative to the benchmark.

Mr. Lynch stated that Cliffwater had two recommendations. The first one was the addition of Luxor Capital Partners. He gave some background on the firm. Luxor Capital Partners currently manages one fund which has \$5.7 billion in assets. The strategy is event-driven with a focus in middle-market companies. Luxor invests across the capital structure of companies. He reviewed the fund's performance. Since inception, the fund has generated a 17.5% return with a volatility of 12.2%. It ranks in the top 13% of all event-driven managers in the universe. He added that Luxor has two share classes. One offers higher liquidity with a higher fee structure. The other is lower liquidity (2 year lockup) with a lower-fee structure (1.5% management and 17.5% incentive fees).

Mr. Lynch said Cliffwater also recommends redemption from Indus Asia Pacific Fund due to underperformance and changes in the roles of the fund's managers. He said that ERSRI has an opportunity to invest in a fund with a similar, somewhat broader strategy. Cliffwater recommends Emerging Sovereign Group (ESG) Cross Border Fund as a replacement for Indus Asia Pacific Fund. This fund invests in emerging market countries on a global basis, not just Asia. Mr. Lynch gave a brief review of the firm. Since inception, the fund has produced an annualized rate of return of 11.76% with a standard deviation of 8.98%. Relative to the peer group, the fund ranks in the top decile. Management fees are 1.5% and a performance fee of 20% with a high water mark, meaning if they produce losses they must make up for losses before they can get a performance fee. They provide quarterly liquidity with 60-day notice. The board discussed the recommendations.

On a Motion by Mr. Fay and seconded by Mr. Mullaney, it was unanimously **VOTED: to redeem from the Indus Asia Pacific Fund.**

A motion was then made by Ms. McNamara and seconded by Mr. Mullaney, and it was unanimously **VOTED: to approve a \$50 million investment into Luxor Capital Partners.**

A motion was then made by Mr. Costello and seconded by Ms. McNamara, and it was unanimously **VOTED: to approve a \$50 million investment into ESG Cross Border Equity Fund.**

VI. Real Estate Review—Quarterly Review

Mr. Glickman gave an introduction to his review of the state of the real estate market. The portfolio's target allocation is 8% and the actual allocation is currently at about 5% including commitments not yet drawn. The target is to make the commitments of about \$220 million over the next two years in order to reach the 8%. He noted that PCA suggests committing to fewer managers with larger investments.

In terms of the overall commercial real estate markets, there is reasonable equilibrium between supply and demand for space. In office, PCA is less apprehensive than they have been. They still think that there needs to be more recovery in the overall economy to convince decision makers to take more space. In the apartment sector there seems to be a quicker response to the demand for apartments and the creation of new supply. Of the four main real estate types, apartments have had the best overall combined performance between income and appreciation. As a result, PCA is more encouraged to go into non-core investments such as value-add or opportunistic. They are more open to more aggressive real estate and will suggest the board consider it in the 3rd and 4th quarter and the 1st quarter of next year.

He added that normally if interest rates go up, property values will go down. That didn't happen when rates went up last year. They believe that is because there was still high demand, so prices didn't move. Currently, PCA expects that as interest rates move up over time, cap rates will probably move up as well making properties worth slightly less. However, the fact that the economy is recovering and rents rising should help offset that reaction.

Mr. Glickman said that volume of new purchases continues to go up. Net absorptions of new space being taken up is pretty much in equilibrium with how much new space is being created. There is still enough vacant space to accommodate people that want space.

Overall, PCA is pleased with the way the portfolio performed. The portfolio did not meet the benchmark last year; however, they think that the portfolio is moving towards it.

The board asked questions.

VII. Legal Counsel Report

There was no legal counsel report.

VIII. CIO Report

Ms. Fink gave a review of the performance for the month of March. After a weak January and a strong February, March was largely a calmer month. The portfolio rose 0.25% which puts it at a 11.3% return for the fiscal year-to-date. For the month, the portfolio slightly lagged the bottom-up benchmark and beat the 60/40. The portfolio's risk was 7.5%, which is better than both benchmarks. She added that the risk-reward balance and the asset allocation in the portfolio are working.

Ms. Fink said the best performers in March were emerging market equities and private equity. The weaker performers in the month were some of the hedge funds and the traditional fixed income. Other asset classes that were down were those tied to interest rates like core fixed income and the inflation-link bonds. Bonds were down between 0.2% and 0.3%. She said the good news is that floating rate bonds were not affected, so the floating rate credit investments were up 0.3% on the month.

She said that looking forward, efforts will continue to be to reduce hedge fund beta and to rebalance equity overweights. Those moves have helped performance and have reduced the portfolio's sensitivity to equity market moves. After last year's strong up move and with earnings multiples above long-term averages she expects more temperate returns from the overall market. Therefore, the goal will continue to be to keep reducing the portfolio beta and diversify the asset allocation.

IX. Treasurer Report

Treasurer Raimondo thanked the board and commended them on their continued work. There being no other business to come before the Board, on a motion by Mr. Mullaney and seconded by Ms. Reback, the meeting adjourned at 11:01 a.m.

Respectfully submitted,



Gina M. Raimondo
General Treasurer